DEPARTMENT OF STATE REVENUE

02-20150316.LOF

Letter of Findings: 02-20150316
Corporate Income Tax
For the Years 2010-2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Multinational Corporation's I.R.C. § 162 consulting fee business expense was disallowed because the expense's sole purpose did not qualify for the deduction. Corporation did not qualify for the deduction because it could not prove services were actually rendered.

ISSUE

I. Corporate Income Tax - Imposition.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; I.R.C. § 162; I.R.C. § 482; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,*867 N.E.2d 289 (Ind. Tax Ct. 2007); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of Revenue v. Miller Brewing Co.*, 975 N.E.2d 800 (Ind. 2012); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Welch v. Helvering*290 U.S. 111 (1933); Treas. Reg. § 1.162-7; Treas. Reg. § 1.482-2(b)(3); Black's Law Dictionary (9th ed. 2009).

Taxpayer protests the Department's proposed assessments.

STATEMENT OF FACTS

Taxpayer is an out-of-state multinational S-corporation doing business in Indiana and outside of Indiana. Taxpayer licenses franchise stores and leases equipment under the franchise agreements. Taxpayer is owned by two shareholders. Taxpayer licensed multiple independently owned stores in Indiana. The two shareholders are also the sole shareholders and employees of another company that offers its consulting services to Taxpayer ("Consulting Firm"). In other words the same shareholder owns both companies. Taxpayer and Taxpayer's shareholders file Indiana income tax returns based on income from Taxpayer not the Consulting Firm.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's business records for tax years 2010 through 2012. Pursuant to the audit, the Department made various adjustments which resulted in additional tax assessed to Taxpayer. Taxpayer protested. An administrative hearing was held. This Letter of Findings ("LOF") ensues. Additional facts will be provided as necessary.

I. Corporate Income Tax - Imposition.

DISCUSSION

As a threshold issue, all tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,*867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc*., 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *see also Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014) (*citing UACC Midwest, Inc. v. Indiana Dep't of State Rev.* 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). In addition, an S Corporation - such as Taxpayer - is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009). Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine an individual shareholder's tax liability. Furthermore, any additional income received by the S-Corp as a profit passes through to the individual shareholders as income. Thus, while the protest is regarding Taxpayer, the result will flow through to the shareholders.

During the audit, the Department determined that Taxpayer improperly reported its income. As provided in the audit report, "[a]n adjustment was made for all years to add back the deduction taken by Taxpayer for fees paid to the Consulting Firm," thus, causing Taxpayer's ordinary income to increase to "fairly reflect income from Indiana sources." The audit report cited to IC § 6-3-2-2(*l*), giving the Department the authority to employ other methods to "effectuate allocation and apportionment of the taxpayer's income" in order to fairly reflect Taxpayer's Indiana sourced income. The audit report also cited IC § 6-3-2-2(m) which "states that in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers."

The audit report examined the documentation provided by Taxpayer and determined that the consultation fees were deducted from Taxpayer's Indiana income for the sole purpose of shifting income to a non-taxable state. The consultation fee was set forth in a 1993 "Consultation Agreement," and confirmed by a 2010 letter. Both the agreement and the letter stated that Consulting Firm was to be paid an amount equal to half of Taxpayer's income if Taxpayer's annual net income was not lower than Taxpayer's income, depending on whether it was above or below the set amount averaging in the half a billion range. This "fee" constituted almost three-fourths of Taxpayer's annual net income for 2010. According to the audit report, the Agreement provided that:

> [Consulting Firm] shall consult with and advise [Taxpayer] regarding the following matters: Providing [Taxpayer] with its expertise and knowledge of the franchising industry; [p]roviding assistance with the marketing of franchise concepts; [p]roviding [Taxpayer] with its skills in the promotion of [Taxpayer's] franchise concept through the use of media, publicity, and public relations. Such consulting and advising services shall include but not limited to: site selection, identify markets for expansion, product selection equipment selection, [product] changes/pricing/promotion, responding to competition, franchise pricing, financial controls and cash management, and dealing with government regulatory authorities.

According to the audit report, all the services that Consulting Firm provides should already be provided by Taxpayer, which as a reminder is owned by the same two shareholders who own Consulting Firm, and that Taxpayer should not have a separate company (which consists of the same shareholders) being paid for the same services; "[i]n essence, this is distorting the net income of [Taxpayer]." The audit report also stated that:

> Most consulting agreements are based on time spent by the consultant on a project or, in some cases, a percentage of cost savings and that is usually a contingency contract in which no fee is paid unless certain criteria or accomplishments are met. Research on consulting fees did not reveal anything close to [half of the income] fee. The consulting and letter agreements did not set forth any criteria for the [fee] other than a 1991 net income number for [Taxpayer]. In essence, there was no other set criteria listed that, if met, would justify the [fee].

The audit based the adjustment on the fact that:

> [T]he lack of a transfer pricing study to back up the 1993 and 2010 agreements is problematical since it shows there is no 3rd party contemporaneous confirmation that the fee was determined to be at arm's length. In fact, given that 2 officers of [Taxpayer] are the same two officers and employees of therefore distorts the income of [Taxpayer] and does not allow for [Taxpayer's] income to fairly reflect its income derived from sources inside Indiana. The payment of a flat percentage of sales with no basis for this franchise fee, resulted in a reduction of apportionable Indiana income by approximately 99[percent].

The audit report also stated that Taxpayer also paid several independent third parties ("Third Parties") to provide the same or similar services. According to the audit report, one agreement between an Third Parties and Taxpayer stated that:

> [Third Parties] agrees to develop and service [Taxpayer's] [franchise] including but not limited to the following: advertising for prospective franchisees; providing prospective franchisees with information about the Company; providing site selection and lease negotiation advice and assistance to the Company and its franchisees; providing construction advice [. . .]. [Third Parties] will provide advertising, marketing and profit building advice, direction and training to franchisees.

During the audit, Taxpayer was asked to provide a transfer pricing study or any other documentation that would demonstrate the arm's length nature of the consultation fee. Taxpayer did not provide any of the requested information. Taxpayer's response to the document request was, that it believed "the deduction is at arm's length and is an ordinary and necessary business expense for [Taxpayer]."

The audit made the adjustment pursuant to IC § 6-3-2-2(*l*) (as in effect for the tax years at issue), which provides "[i]f the allocation and apportionment provisions . . . do not fairly represent the taxpayer's income derived from sources within the state of Indiana, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The audit report went on to note that the purpose of the adjustments is to "fairly reflect . . . the income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(m).

It is clear from the language in IC § 6-3-2-2(*l*) that the preferred method of filing returns is the standard apportionment or separate company filing method of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment should only be allowed when those provided for by IC § 6-3-2-2 do not fairly reflect Taxpayer's Indiana income.

During the audit, Taxpayer was asked for alternatives to correct this distortion and none were given. The audit report stated that "separate accounting applies when there are different business lines but that is not the case here. Combination allows factor relief and eliminates all intercompany expenses but with both companies being S corporations, combination does not work." The audit report concluded that the consultation fees paid to Consulting Firm distort Taxpayer's income by artificially reducing Taxpayer's Indiana sourced income and is nothing more than an attempt to shift income away from a separate return state such as Indiana.

Taxpayer protests the add back of the fees based on the fact that there was no common ownership or control over Taxpayer and Consulting Firm, and that services provided by Consulting Firm are ordinary and necessary business expenses. Each argument shall be addressed separately and analyzed below.

I. Ownership and Control

IC § 6-3-2-2 provides:

> (*l*) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or

> indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

Taxpayer argues that it does not own the Consulting Firm and vice versa. Taxpayer states that the entities are "separate and distinct enterprises." Taxpayer "has a roster of officers and directors that include multiple individuals" aside from the two main shareholders. Thus, Taxpayer argues that it has no ownership over Consulting Firm and IC § 6-3-2-2(m) does not apply. However the statute clearly states "ownership **or** control." *Id*. IC § 6-3-2-2(m) was created to link separate entities when there are clear ownership or control issues to clearly reflect Indiana taxpayers' income.

While it is true that Taxpayer has multiple directors on its board, it is also true that the president of the board is one of the shareholders and directors for Consulting Firm and the other shareholder and director of Consulting Firm also sits on Taxpayer's board. The same shareholders of Taxpayer and Consulting firm sit on each board and hold officer positions on each board. Clearly, there is a direct ownership link between Taxpayer and Consulting Firm. Therefore, the Department was within its statutory authority to adjust Taxpayer's income to fairly reflect its business activities in Indiana and its Indiana income. IC § 6-3-2-2(m).

1) I.R.C. § 162 Business Expenses

Taxpayer argues that the expenses are ordinary and necessary business expenses as defined under I.R.C. § 162 and *Welch v. Helvering*290 U.S. 111 (1933).

I.R.C. § 162 states that:

> (a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including–
> (1) A reasonable allowance for salaries or other compensation for personal services actually rendered;
> (2) Traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
> (3) Rentals or other payments required to be made as a condition to be continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

First, Taxpayer must show that the amounts were actually paid or incurred during the taxable year. Next, Taxpayer must also show that the claimed expenses are "ordinary" and "necessary" business expenses. The Department will first determine whether Taxpayer meets prong 1 of I.R.C. § 162(a).

a) Services provided by Consulting Firm

In 1993 Taxpayer entered into Agreement with Consulting Firm to provide services for Taxpayer. The relevant portions of the agreement state:

> Whereas, [Taxpayer] recognizes that in light of its prior growth rate and current competitive pressures that it will continually need advice and expertise with regard to maintaining its current position and expanding it where appropriate; and
> . . .
> [Taxpayer] hereby engaged the services of [Consulting Firm] to perform the following services in accordance with the terms and conditions set forth in this Agreement:
>
> [Consulting Firm] shall consult with and advise [Taxpayer] regarding the following matters:
>
> Providing [Taxpayer] with its expertise and knowledge of the franchising industry,
> Providing assistance in the marketing of franchise concepts
> Providing [Taxpayer] with its skills in the promotion of [Taxpayer's] franchise concept through the use of media, publicity, and public relations.
>
> Such consulting and advisory services shall include but not limited to the following:

Site selection
Identify markets for expansion
Identify needs of specialized markets
Logos/décor and other items subject to trade mark
Product selection
Equipment selection
[Product changes]/pricing/promotions
Responding to competition
Local/national advertising:
Other forms of promotion . . .
Franchise pricing. . .
Dealing with Governmental Regulatory Authorities and Environmental concerns.

Taxpayer has provided no proof that the services were actually provided by Consulting Firm. Taxpayer provided the Agreement and a list of its services but did not provide evidence that Consulting Firm actually provided any of those services. According to Treas. Reg. § 1.162-7 a taxpayer must show that services were actually rendered. In this instance, Taxpayer has provided no invoices, emails, purchase orders, or any other type of documentation to show that services were in fact rendered. Therefore, because there is no proof that services were actually rendered Taxpayer fails prong one of I.R.C. § 162(a). There is no need to analyze whether Taxpayer meets prong two since it failed under prong one. However, it is worth noting that the Department is not convinced that it is "ordinary" or "necessary" for the owners to pay themselves to advise themselves, particularly when they're simultaneously paying the Third Parties to provide the same services.

b) Arm's Length Transaction

Even if Taxpayer could show that its expenses qualified under both parts of I.R.C. § 162(a), it has not provided sufficient documentation to show that the expenses were at arm's length. The agreement states that Consulting Firm shall be entitled to an amount of that is more than 50 percent of all gross income received by Taxpayer at the end of each quarter. Furthermore, Agreement called for upward adjustments in the consulting fee based on whether Taxpayer's quarterly income rose above $1.75 million. The Agreement also states that "at a minimum one consultant [assigned] to [Taxpayer] will spend approximately twenty-five hours per week to fulfill [Consulting Firm's] obligations in accordance with this Agreement;" the amount of time may vary from week to week. The Agreement also states that "at a minimum the consultant must devote a minimum of one hundred hours per month to fulfill [Consulting Firm's] duties in accordance with this Agreement." This translates to one of the two consultants earning $2,450 per hour each quarter. At worst, in the event Taxpayer's income was less than $1.75 million, then Consulting Firm's payment would be reduced for each quarter in an amount necessary to have Taxpayer's net income equal to $1.75 million. In addition, the Agreement allowed Taxpayer to terminate the Agreement if Consulting Firm failed or refused or neglected to render services.

Taxpayer argues that this agreement was executed at arm's length. Taxpayer argues that Consulting Firm provided franchising expertise and has been instrumental to Taxpayer's success and growth over the past fifteen years. Taxpayer reasoned that, "Indiana regulations do not provide guidance on arm's length pricing." Thus, Taxpayer turned to I.R.C. § 482 to determine what is "arm's length."

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.
>
> I.R.C. § 482.

To further explain "arm's length," Taxpayer cited to Treas. Reg. § 1.482-2(b)(3), providing "that the arm's length standard is generally defined as the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." Further, Taxpayer explained that the payment structure with Consulting Firm is similar to that with Third Parties.

> The [Third Parties] receive a fee equal to [one-third] of royalties and half of the franchise fees [Taxpayer] receives from their franchisees. Comparatively, [Consulting Firm] receives a payment equal to 56[percent] of royalties [*sic*] received by [Taxpayer] from their franchisees (pursuant to a formula that was negotiated in 1993 and memorialized in the aforementioned Agreement).

The Department does not find Taxpayer's arguments credible. First, it is unreasonable to say that the agreement with Taxpayer and Consulting Firm was at "arm's length." Consulting Firm is paid over half of all gross income from Taxpayer for each quarter come rain or sunshine. Taxpayer has not provided a transfer pricing study. Thus, the Department does not find Taxpayer's argument that these fees are at arm's length.

Second, while Taxpayer provided bank statements to show that money was transferred to Consulting Firm, these payments however, were monthly accruals of annualized projections based upon monthly revenue meetings, not based upon the Taxpayer's income pursuant to Agreement, even though the Agreement itself is questionable. Taxpayer did state that the projection accruals are reconciled with revenue earned by Taxpayer, however even if reconciled, Consulting Firm could have been receiving an advance for "services" that it may or may not have performed, and even if it performed *some* services the compensation for those service are not at "arm's length." Therefore, the Department cannot agree that the agreement is at arm's length.

The audit report correctly determined that "Taxpayer has set up a separate corporation to pay the same two people, who are officers of the first corporation, for advice to themselves." The consulting fees unnecessarily lower Taxpayer's Indiana income. This scheme Taxpayer has tried is an attempt to shift income away from Indiana to a separate low income tax state.

Taxpayer has not met its burden under IC § 6-8.1-5-1(c). Taxpayer provided no documentation to show that services were actually rendered to qualify its expenses under I.R.C. § 162(a). Furthermore, even if Taxpayer could show that it qualified for the expense under I.R.C. § 162(a), it could not show that the expenses were at arm's length. Thus, the Department was correct in its determination that Taxpayer is distorting its Indiana income and attempting to shift income away from Indiana. For the reasons stated above, Taxpayer's protest is denied.

FINDING

Taxpayer's protest is denied.

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